Reducing International Imbalances in an Interdependent World

I am pleased to have this opportunity to address the Bankers' Association for Foreign Trade (BAFT) in part because few trade organizations are more on the cutting edge of a host of important issues affecting the United States and the world economy as is yours. Consistent with that, I can't help but think that when your president-elect, Bill Rhodes, asked me to appear here this morning he had in mind that I would provide at least something by way of a Federal Reserve perspective on the LDC debt situation. Since I don't want to disappoint Bill, I will have something to say on that subject a little later. However, as a prelude to that, I want to review certain aspects of the U.S. external economic and financial situation with emphasis on how, from my perspective, we can best go about the orderly process of winding down our massive trade and current account deficits. I want to do that in part because that process is obviously important in its own right, but also because how that adjustment is made is highly relevant to future prospects on the LDC front.

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Let me begin by reviewing very briefly several factual aspects regarding our external situation with emphasis on both the proximate and the underlying causes of our current predicament. Using the three-year period between the fourth quarter of 1982 and the fourth quarter of 1985 as points of reference, the situation can be summarized as follows:

- Over that period, the U.S. current account deteriorated by $120 billion plus. As a matter of comparative arithmetic, the extent of the drag on GNP resulting from the increase in the trade deficit was roughly the equivalent of one-third of total consumer spending for all durable goods.

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- While much emphasis is placed on the U.S bilateral trade deficit with Japan—and rightly so—the extent of the deterioration in the U.S. trade deficit with Europe since 1982 was slightly larger than was the case with Japan.

- Similarly, U S *imports* from Canada, from Europe, and from the LDCs are each larger than are U.S. imports from Japan.

- On the financial side, the cumulative current account deficit of the United States over the past three years has been a staggering $270 billion. Reflecting those

Remarks of E Gerald Corrigan, President, Federal Reserve Bank of New York, before the 64th Annual Meeting of the Bankers' Association for Foreign Trade on Saturday, May 17, 1986 cumulative deficits, the United States has quickly gone from a large net creditor nation to a very large, and soon to be, if not already, the largest net debtor nation in the world. Indeed, it is a virtual certainty that the net external indebtedness of the United States will approach one-half trillion dollars by the end of the decade, constituting not only a heavy mortgage on future generations, but also implying external debt servicing costs that will make it all the more difficult to approach a current account balance even in the long run.

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While these factual aspects of the situation are easy to cite, disentangling the reasons for these developments is not. But, if we are to have a coherent and workable approach to reversing these imbalances, we must have a reasonably good fix on what it was that produced the imbalances in the first place.

The simplistic answer to the question is, of course, that over much of the 1982-85 period the dollar was "too strong." That simplistic answer is, however, unsatisfactory on at least two counts: first, it does not explain why the dollar was "too strong;" and second, whatever the reasons for the strong dollar, it is clear that the exchange rate itself was not the sole source of the problem. Let me elaborate on these points.

The question as to why the dollar was "too strong" is not an easy one to answer in part because so much of what we see in the exchange markets takes the form of that great intangible, market psychology. Nevertheless, several things do suggest themselves. For one, the simultaneous presence in the United States of lingering inflationary expectations, and a rising level of domestic demand and investment in the face of massive budget deficits clearly helped produce a situation in which nominal and real interest rates were quite high over much of the period. That situation, together with the associated huge domestic savings gap, made a strong dollar both inevitable and, ironically, necessary. Those basic forces were, no doubt, accentuated by the observed—and I might add the unwelcome—tendency of the exchange markets to overshoot once a strong trend is in place—a tendency which in this instance may have been reinforced by market perceptions of a "hands off" policy on the part of the U.S. Government over most of the period in question.

However, economic performance in the United States over this period is only part of the story, for events in the rest of the world were accentuating the pressures stemming from developments in the United States. In the industrial countries, for example, distinctly sluggish growth in domestic demand was suppressing their propensity to import and strengthening their propensity to export while the debt problems in many of the LDCs were producing similar pressures in those countries. Subpar economic performance throughout much of the world together with strong expansion and relatively high interest rates in the United States combined to produce a situation in which the foreign demand for dollar-denominated assets was strong. This in turn produced the seemingly anomalous situation in which the United States was able to finance a large and growing current account deficit with an appreciating currency—a tendency which was helped along by the "safe harbor" characteristics of U.S. investments.

In any event, looking beneath the statistics, it would seem safe to conclude that the dollar was "too strong" over much of the 1982-85 period because of the size of the U.S. budget deficit relative to available domestic savings; relative economic performance in the United States versus performance in the other industrial countries and the LDCs; the "safe harbor" character of U.S. investments; and the tendency of the market to overshoot

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That perspective on what happened and why it happened is important for a number of reasons, not the least of which is that it should serve as a forceful reminder that just as a rising exchange rate alone did not cause the problem, a falling exchange rate alone cannot solve the problem. Indeed, in some very important respects we have been fortunate that the recent drop in the dollar exchange rate has not seemed to materially impair the willingness of foreigners to increase their holdings in dollar-denominated assets—something which, if it did occur, could have very adverse consequences for U.S. interest rates and for economic prospects here and around the world.

The recent willingness of foreigners to acquire dollar assets in size in the face of a falling exchange rate and falling interest rates seems to reflect a number of considerations. For one thing, because interest rates abroad have

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also declined, dollar interest rates still maintain a favorable—although significantly narrowed—spread over competing instruments abroad. For another, the United States remains an attractive investment outlet, in part because economic performance and prospects here still look good in both absolute and relative terms. However, in looking at the last six months or so, there can be little doubt that one very important factor supporting the continued flow of foreign funds into the United States has been the very substantial appreciation of the capital value of stocks and bonds. Indeed, depending on the particular investment in question and the precise timing, the rise in stock and bond prices has, to foreign investors, importantly, if not fully, offset the declining value of the dollar. Looking to the future, it seems to me that we should also keep that perspective in mind because the sheer size of the recent rise in stock and bond prices raises at least a question as to how much further stock and bond prices can rise in the near term. That, of course, is simply another way of saying that sensitivities associated with exchange rate developments remain high and, in some ways, have increased.

With these considerations in mind, the obvious question before us is how do we go about the task of an orderly shrinkage in our massive external account deficits? To begin to answer that question, several key points of reference need to be kept in mind. Among them are the following:

- For a group of countries including Canada and the Latin American and Asiatic LDCs—countries which account for roughly half of our foreign trade—there has been virtually no net depreciation of the value of the dollar and, in a number of cases, notably Canada, the value of the U.S. dollar has actually appreciated in recent months.

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- For obvious reasons, the adjustment in the U.S. trade position should not and cannot come largely at the expense of the heavily indebted LDCs.

- The emphasis which is placed on more rapid growth in the other industrial countries is properly placed but I'm not sure the extent of the problem is fully understood because of the tendency to look at comparative growth in GNP as the yardstick for assessment. In point of fact, what matters for these purposes is not so much the growth in GNP but the growth in domestic demand. For example, over the last three years the growth in domestic demand in the United States has been very robust and well in excess of the growth in GNP, with the difference accounted for by the rise in our trade deficit. For the other industrial countries, the growth in domestic demand has been distinctly short of that in the United States and, of course, also short of the growth in their GNPs. What follows, of course, is that even if rates of growth in GNP were to converge in the 3 to 3.5 point range, an improvement in the U.S. trade position with the other industrial countries can come about only if higher rates of GNP growth in those countries are also accompanied by still higher rates of growth in their domestic demand

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- Finally, as painful as the reality may be, it is neither possible nor desirable to achieve a full reversal in our external trade deficit in a year or two or even three. The trade and associated current account deficits can come down in an orderly way only as a part of an overall process in which the U.S. domestic savings gap is narrowed; economic performance abroad strengthens; and inflationary pressures in the United States stemming from the dollar's fall are contained Any attempt at shortcutting these essentials would entail sizable risks of interest rate and inflationary developments in the United States and growth developments elsewhere that could be very destabilizing.

Looked at in that light, it seems to me that important progress has been made in establishing the fundamentals which can put us on the path of orderly adjustment. However, if we are to successfully stay the course, we must keep in mind not just what has been accomplished but also what remains to be done. Staying that course seems to me to require several things:

- First, we must recognize that the optimal correction in our external position will be one in which the bulk of the adjustment takes the form of more rapid growth in exports This is not to say that we should not expect and welcome some relief on the import side. In fact, the oil price is already providing some help and exchange rate-induced rises in import prices will help further. But, whether viewed from the perspective of domestic inflation, growth in the world economy, or growth in the world trading system, greater export expansion offers a more promising approach than does suppressed imports. While I do not claim to be an expert on trade policy, I cannot help but think that it would be in everyone's interest if that process were pushed along by a greater effort on the part of all of our major trading partners to reduce artificial barriers to U.S products.

I would hasten to emphasize again that the solution to our external problems cannot come from the exchange rate alone and, as a related point, that in the current setting, we must be especially sensitive to the dangers of overshooting on the downside—the consequences of which could be quite severe.

- Second, obviously there had to be and has been a change in exchange rate relationships. Indeed, in looking at the post-Plaza environment, I would characterize overall developments as broadly constructive. Having said that, I would hasten to emphasize again that the solution to our external problems cannot come from the exchange rate alone and, as a related point, that in the current setting, we must be especially sensitive to the dangers of overshooting on the downside—the consequences of which could be quite severe.

- Third, we must reduce the size of our domestic savings gap. In the timeframe of the next two or three years—even assuming the best by way of incentives from tax reform efforts—that reduction can only come about in a constructive way by reducing the financing requirements of the budget deficit. In that connection, the budget targets contained in Gramm-Rudman-Hollings for 1988 would, if they are attained, provide the room to finance a reasonable rate of private investment *and* the remaining budget deficit largely from domestic savings. Recent developments on this front have also been encouraging and have already been discounted to some extent in interest rates but, make no mistake about it, the really hard work lies ahead.

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- Fourth, we must also have more growth—not export led growth, but growth in domestic demand—in the other industrial countries. The recent reductions of interest rates in these countries, combined with the benefits of lower oil prices, should provide important stimulus for such growth but, as yet, it is hard to see pervasive and clear evidence of a marked pickup in their domestic activity. This, of course, raises the question of whether further monetary or fiscal stimulus might be needed—a question which must be viewed in a context that recognizes that it is in everyone's interest to see a reduction of the world's trade and payments imbalances.

- Finally, as an important part of the equation, we must also have better economic performance out of the LDCs Surely, as mentioned earlier, the financial position of the debt-burdened LDCs requires that they as a group maintain relatively large trade surpluses. But, here too, there is a right way and a wrong way to achieve that result. The wrong way is via artificial import restraints which can only stand in the way of needed structural reforms; the right way is in the context of more open and growing economies in which exports are rising, but so too are imports, including imports from the United States. In point of fact, from my perspective, the great value of the approach to the next phase of the LDC debt situation put forward by Secretary Baker lies not just in its emphasis on structural adjustment in the LDCs, a larger role for the multinational development institutions, and prudent amounts of added bank financing, but in the manner in which the interaction of all of these factors can produce a result which is not just good for the LDCs and their creditors but is distinctly positive for world trade including U.S. exports.

In looking at any or all of these areas, three things stand out; first, progress, important progress, is being made on all fronts; second, despite that progress, much remains to be done in a context in which the rewards for patiently seeing it through will be great while, on the other hand, the costs of drifting off course could be immense. Third, the approach I have suggested is a package deal. That is, each component part is dependent on the others such that a failure to deliver on any one front will jeopardize prospects on all other fronts.

Perhaps nowhere is that interdependency more evident than in the case of the LDC situation. Indeed, even now—or perhaps I should say especially now—we must keep firmly in mind that continued progress on that front is not just in the best interest of the LDCs themselves or their large creditors, but is unambiguously in the best interests of growth and stability for all—big banks or small banks, farms or factories, foreign or U.S. concerns. Myopia has no place in this arena. Consistent with that, I believe the Baker initiative deserves and is receiving broad-based support in a setting in which the catalyst for action and implementation properly lies with the policy initiatives of the LDCs themselves.

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In closing, let me add a word or two about official supervisory attitudes toward fresh money lending by U.S. banks to the LDCs which, of course, is an essential component part of further success in coping with the international debt problem. Needless to say, our approach starts with the recognition that decisions to lend to any borrower are the sole responsibility of a bank's management and directors Similarly, all banks are expected to have adequate capital and reserves to cover risks associated with the bank's overall portfolio and related activities Within that framework examiners have, of course, a continuing responsibility to judge the adequacy of bank capital, reserves, and related control systems The examiners will exercise these responsibilities on a case-by-case basis in a way that need not rely on uniform or inflexible formulas. Judgments about the adequacy of reserves will therefore take account of the methods and systems used by individual banks to determine the appropriate level of such reserves and by taking into consideration the overall condition of the individual bank. Within that framework, fresh money lending to the LDCs certainly is not automatically subject to classification or reserving, especially when such lending is part of an internationally supported program of structural change, one aim of which is to strengthen the economic performance of the country in question and thereby enhance its debt-servicing capacity. Thus, just as the general approach to the LDC debt problem has been predicated on a case-by-case approach, so, too, will supervisory attitudes regarding capital and reserve adequacy. In this regard, it should also be stressed that we have already witnessed a dramatic drop in bank exposure to the troubled LDCs relative to capital and, even with the modest new lending contemplated by the Baker plan, significant further progress in this regard will be forthcoming over the next three years.

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In short, the modest added lending contemplated by the Baker plan is quite compatible with prudent banking and prudent banking supervision. Moreover, it is also compatible with the broader objective of restoring the health and vitality of the economies of the LDCs and thereby furthering the cause of global stability and prosperity.

I said at the outset that BAFT was on the cutting edge of a series of vital issues. Because of what you are and who you are the vision and leadership you can provide can help make the difference. In all of the areas I have spoken about it seems to me that common interests far outweigh particular interests. In that spirit, it also seems to me that success will come sooner and bring larger rewards if we are all prepared to keep that common perspective; a rising tide truly does lift all the boats.

Thank you.